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Chapter 3

BANKING AND FINANCIAL MATTERS ON CROATIA'S ROAD TO THE EUROPEAN UNION

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ABSTRACT

The ability of a country to meet the criteria for financial convergence on the EU depends on four key factors: the behaviour and structure of the banks and non-banking financial service providers, the degree of development of the money and capital markets, the regulatory environment and the openness of the country to international financial currents. In this work the factors that work in favour of a rapid accession by Croatia to the EU and those that are the key areas of vulnerability on the same road are identified. The first group of factors includes the developmental level of the banking system, whose structural characteristics (competitiveness, ownership structure and scope of financial mediation) work in favour of rapid integration. This group also includes the standardising regulatory framework, the changes in which over the last few years have brought Croatia very close to the standards of the EU. Non-banking financial service providers are relatively undeveloped; however, where the investment and pensions funds are concerned, their development and the regulatory environment, rapidly converging on international standards, guarantee imminent ability to be included in the integration processes. The main areas of vulnerability are the undeveloped share capital market and a restrictive attitude with respect to international financial flows.

Key words:
financial market, capital market, convergence on the EU, international capital flows, banking system

INTRODUCTION

The financial issues on some country's road towards the EU are usually brought down to those of whether the country is converging in terms of the quantitative criteria of Maastricht (amount of inflation, interest rates, public debt, fiscal deficit, currency stability). Sometimes the issue of the harmonisation of the standards with the legislation of the EU is highlighted. However, the most essential capacity of a certain country to meet the financial and associated standardising parameters of the EU depends primarily on the structure and behaviour of its institutions: the behaviour and structure of banks and non-banking financial services or institutions, the degree to which the money and capital market is developed; the regulatory environment and the openness of the country to international financial flows. In this paper we shall show that Croatia has the characteristics of an advanced country in connection with most of these criteria. A considerable lag can be noticed in the area of the development of the capital market and openness to international financial flows, which might in the future turn out to be serious sources of vulnerability in the process of Croatia's accession to the EU.

BEHAVIOUR AND STRUCTURE OF FINANCIAL SERVICES

The figures in Table 1 show a comparison of long-term interest rates in Croatia and in other transitional countries. Although the Maastricht criteria would tend to require a comparison of interest rates on long-term government bonds, the long-term interest rates on commercial bank loans shown in the paper demonstrate the ability of the banking system to mediate between the demand for and supply of financial resources, which belongs to the group of convergence criteria that are not measured by an unambiguously defined indicator. In spite of this, the competitiveness of the entire financial services sector is interpreted as an important structural precondition for EU membership.

Long-term interest rates in Croatian banks were greater than those in the Czech banks (among the transitional banks) as recently as the end of 2000. As against the average in the EMU, there was at that time a still large 3 percentage points. Then the reduction of interest rates occurred, and they continued to converge on the European level. In the middle of 2002, these rates were almost completely the same as the Czech rates. They were larger than those in the EMU by only slightly more than one percentage point.

Table 1. Long-term interest rates charged by commercial banks on loans (%)

Country	2000	June 2002
Czech R.	8.1	6.6
Hungary	13.4	10.5
Polanda	21.4	13.8
Slovakia	9.6	9.8
Slovenia	18.4	15.5
EU	6.2	5.9
Croatia	9.3	7.1

Source: HNB

If one factors in the fact that inflation in Croatia is converging on EU criteria and that the trends in the exchange rate can already be interpreted as harmonisation with EU criteria (see Mihaljek's paper in this collection), fiscal issues remain the only really open financial questions on Croatia's road to the EU (Table 2). We shall not offer any separate debate on fiscal indicators here since they are handled in detail in the chapter of Mihaljek.

Table 2. Summary view of the outlook for meeting the Maastricht criteria

Criterion	Criterion met in 2001	Criterion expected to be met in 2002 or 2003	Long-term trend
Inflation	no	yes	good
Interest rate	no	yes	good
Exchange rate	yes	yes	good
Budgetary deficit	no	no	cannot be estimated*
Public debt	yes*	yes*	cannot be estimated*

** The methodological discrepancy of the fiscal accounts, especially of the accounts of the quasi-budgetary corporations such as HAC, Croatian Motorways, and the quasi-budgetary funds after 2000, and the failure to be up to date in the publication of the fiscal statistics (from August 2002 only the data from April were publicly available), make every attempt to estimate a long-term trend inadequately serious. Since the long-term trends in the public debt depend on the long-term trends in the budgetary deficit, the long-term trend of the public debt cannot be estimated, although its current level (around 40% of GDP, if government guarantees are not included, and more than 50% if they are) is still considerably below the level allowed according to the Maastricht criteria (60% of GDP).*

The measurable financial parameters should be looked at as the surface structure indicators of deep level power relations in society, which are reflected in the relations in the financial system. It is primarily the quality of institutions and the ability or inability of society to distinguish good and bad solutions in the creation of its economic and social policy that affect these relationships. These lines of force can be read off in the manner of regulating and running central banking, in the manner of regulating and running banking business operations. For this reason, in the sequel, there will be a brief discussion of the standard parameters that have to be satisfied on the road to the EU.

As for central banking, the independence of the central bank charged with the preservation of price stability is one of the fundamental principles of the Maastricht agreement. European institutions with justice insist on this rule, and recent attempts at changing existing laws in the central banks in the Polish and Hungarian parliaments created a fairly stormy reaction from the ECB.[i] Once again one should recall here that these are conditions that are more stringent than those that held good for countries like Spain, Portugal, Greece and Ireland in their EU accession processes. These states mainly adjusted the legislation governing central banking during the process of the formation of the EMU, that is, after they had already become members of the EU. Apart from that, today's applicant countries are faced with respecting a rigid standard. This fact need not be interpreted as the consequence of the deliberate application of double standards by the EU for applicant countries. The greater degree of stringency employed today is the consequence of the degree of finish and the enhanced stability of European standards and institutions as compared with the time when these countries joined. Then the European standards and institutions in the area of banking and monetary policy were largely in the process of being created, and gradual adjustment was the only possible approach.

The Croatian central bank law is on the whole harmonised with European standards to do with the definition of the objective of the central bank (low inflation), the availability of monetary policy instruments (prohibition on direct loans to the government) and the degree of central bank independence (total independence of the executive and limitation on the power of parliament to appoint and discharge the governor and his/her associates). For this reason it is necessary to resist any possible attempt to make inroads upon this standard, unless they are directed towards further strengthening of the independence of the central bank. The reasons for this should not be only of a formal and Eurocentric nature; it always needs remembering that genuine central bank independence and low inflation belong among the basic, fundamental standards of modern market-economy democracies in Europe. Giving up on this standard will open up the Pandora's box of possible inflation, the harmfulness of which has been shown in this part of the world much more often than its rather dubious social benefits.

However, where banking and financial services in general are concerned, toughness in the standards that the applicant countries are expected to respect is much weaker than in the area of central banking regulation and the monitoring of macroeconomic indicators. The situation in the area of commercial banking is like that in the area of central banking of some 10 or 12 years ago. In general it can be said that the European standards are shown in a series of details of legislative solutions and byelaws and regulations. However, more important than the understanding of the regulatory particularities (to be discussed below) is the understanding that the possibility of the financial system's acting in line with European regulatory approaches depends on the degree of its development and its ability to withstand competition on the open market. From this point of view the Croatian banking system can be considered mature and competitive. This is reflected primarily in the amount of and trends in interest rates (Table 1). Other financial services providers, especially the pensions and investment funds have figured in any strength on the Croatian market only in the last two years, but the character and performance of their operations suggest a probable parallel evolution with the banking system, i.e., rapid convergence with EU criteria. Unlike the banks, these are financial services that previously did not exist in Croatia. Since there is no burden of entrenched institutions and regulatory approaches, from the very beginning they have been able to make use of approaches that are in line with international standards.

As for the investment and pensions funds, the European regulations have still not been rounded off, although with a fair degree of confidence it can be expected that some of the regulatory solutions will soon become obligatory on our funds industry as well. Perhaps the most important regulatory standard is GIPS, the *Global Investment Performance Standard,* which governs the transparent manner of comparing fund performance (manner and frequency of calculating the value of the fund, consolidation of similar funds run by the same management and determination of *benchmarks*, numerical criteria for performance comparison). Since this is not a standard that springs from the process of European unification but a standard that has been adopted, domestic regulators (the Securities Commission) should start the process of importing it into the domestic market as soon as possible. In a similar manner, application of regulatory principles from Basel II should facilitate convergence of the standards framework for the banking industry on EU criteria.[ii]

Measurable financial indicators of harmonisation in standards constitute important criteria, but analysis of convergence with the EU has to go a step further and look more profoundly into the structure of the financial system, for it is on this that competitiveness in the European environment depends. In general, the degree of development of banking services is shown by the relation between banking assets and GDP. The figures in Table 3 show that Croatia is in the group of the most developed European countries, in terms of the banking industry, outside the EU. The Czech Republic has a considerably lower ratio of bank assets and GDP, and Slovakia and Slovenia have a negligibly higher ratio, among the group of countries we are comparing.[iii] It is also important to point out that a comparison with the EU is not relevant, for this average is affected by banking over-developed countries (especially Germany), in which there was a belated development of the non-banking financial services industry (primarily, investment and pensions funds) and of the share capital market, so that the development of the banking system there made up for the deficiencies in non-banking financial services providers. The comparison in Table 4 reveals that countries like Greece lurk below the European average, in which the banking system has not gone on any further than the group of (in banking terms) most advanced applicant countries, which Croatia is closing on. The ratio of banking depth (bank assets/GDP) shows that in 1993 Greece had a banking system at the developmental level of today's Slovakia and Slovenia, or only insignificantly above the other transitional countries with the most advanced banking systems. On the other hand, it should be borne in mind that this conclusion holds only in the comparison with Greece. The next-least developed EU state, Portugal, had a banking depth ratio of 132%, which is considerably more than today's ratio in the advanced transitional countries.

We can conclude that the banking systems in all the applicant countries and in Croatia, but not in Bulgaria, Romania and Lithuania, have reached the degree of development at which they can probably withstand joining the EU system. The relevant historical comparison that inevitably comes to mind to do with the ratio between banking assets and GDP is that with Greece. A comparison with the next least developed EU country, Portugal, leads to the conclusion that there is a great difference between the banking systems of today's transitional countries and that of Portugal in 1993.

In the context of the debate about the competitiveness of the banking systems of the transitional countries, it is interesting to observe the shares of banks owned by foreign banks in total bank assets. Slovenia and Romania are the only applicant countries in which the share of the foreign banks did not, at the end of 2001, exceed 50% (although there are clear indications that there too this share will be reached very shortly). In all the other countries, this ratio is greater. In the CR, Estonia, Latvia, Lithuania, Slovakia and Croatia more than three quarters of banking assets are in foreign-owned banks. The internationalisation of the ownership structure will certainly make it easier to include local banking systems in the financial structure of the EU.[iv] Of course, debate about this necessarily enters the domain of speculation, because EU standards do not prescribe the ownership structures of the banks, and in the EU itself we meet, historically, very different kinds of ownership structure. The ownership structures shown in Greece and Portugal, where there is a negligible number of banks influenced by foreign owners, are typical of a large group of EU states. More recent comparisons, unfortunately, are impossible, because of the absence of any internationally comparable data; however the statistical research carried out by Demirguc-Kunt and Levine (1999) remains an invaluable source. In this dbase the data refer to 1997. On the basis of these data, it can be concluded that we can find an ownership structure like that of Greece and Portugal in Italy, Germany, Norway, Belgium, Sweden and Austria; it is necessary to bear in mind that these data do not reflect the proprietorial influence that the German banks have in Italy, nor the important changes that have occurred in the last five years, among which one should pick out the sale of Austria's biggest bank – Bank Austria – to Germany's HVB, which has fundamentally changed the proprietorial structure of the Austrian banking system. At the opposite pole, within the EU, there are countries with a highly internationalised structure of ownership in the banking system – Ireland, in which, as long ago as 1997, 66% of banks were foreign-owned, and Luxembourg, where foreigners own 58%. The proportion of foreign-owned banks in the UK varies constantly between 20 and 30% of total assets, while the corresponding share in the Netherlands fell to 33% in 1996, after having reached a maximum of 61% in 1992.[v]

Although trends and experiences of individual countries are different, a comparison of the development of ownership structures in the EU and in the transitional countries in the last ten years or so leads to the conclusion that at essence what is concerned is a globalisation process.

For this reason, the applicant countries will in the next few years be faced with problems very similar to those obtaining in the EU, which are:

- the incompleteness of the bank regulation system,
- the gradual exclusion of state ownership from the banking system,
- the public perception of loss of sovereignty because of the appearance of dominantly foreign ownership in the banking system.
- the accelerated development of non-banking financial services providers, particularly of the share capital market.

Table 3. Indicators of level of banking system development, 2001

Country	Bank assets / GDP (%)	Share of banks assets in foreign ownership (%)
Bulgaria	43	70
Czech R.	125	78
Estonia	73	97
Hungary	68	61
Latvia	73	97
Lithuania	33	81
Poland	70	51
Romania	31	39
Slovakia	94	75
Slovenia	94	33
EU	200	n.a.
Greece 2000	115	n.a.
Greece 1993	92	3*
Portugal 2000	203	n.a.
Portugal 1993	132	3*
Croatia	84	82

** Data relate to 1997 (Beck, Demirguc-Kunt and Levine, 1999).*

Source: Bank Austria Creditanstalt, International Financial Statistics, IMF, EBRD Transition Report

Since the globalisation process that results in accelerated financial development and transformation in ownership is common to both the countries of the EU and the applicant countries, the great struggle between the common and the national institutions about authority for the control of the banks within the EU is important for the peripheral countries beyond the borders of the EU. This struggle is being waged between the central banks, or the central supervisory agencies of the EU states (depending on who at the national level is charged with bank and other financial institution supervision) and the Eurocracy, which still does not have a clear view about whether oversight at the EU level should be carried out within the ECB, within the context of the independent-centralised supervisory institution or whether a compromise solution can be found, somewhere between centralising and national aspirations. For the moment, supervision of the banks has remained within national jurisdiction, but at Union level close international cooperation among regulators and supervisors of banks has started, because the operations of a single banks can no longer be supervised only at the centre (as witnessed to by the depiction of the changes in ownership structures and the increasing number of international agreements between financial regulators). The outcome of this tension between international and national control cannot at the moment be predicted even within the EU, and so it is unpredictable with respect to this country as well. In the words of a member of the Executive Committee of the ECB, Mr Tomasso Padoa-Schiopa, stated during a July address to the members of the Economic and Monetary Issues Committee of the EP in 2002, the achievement of unified rules and practices of bank supervision is the objective in the next three to four years. This is also the deadline by which the application of Basel II starts in the regulation of banks (see en ii), which, independently of the process of accession, will lead to the unification of regulatory standards and procedures. Accordingly, this is the temporal horizon within which there will certainly not be any consolidation of the supervisory authorities at the Union level. Europe moves slowly, but surely; and it has left the final answer to the question of regulatory sovereignty to the future political process that is of great importance to us.

Further, it is certain today that the state owned banks in the EU will not be able to obtain full licenses for all banking business. Since any more significant impact of the state-owned banks, particularly the state owned mortgage [hypothec] banks is felt precisely in Germany and Austria, changes in ownership structures here will have direct and indirect impacts on banking in Croatia, through changes in the credit rating or ownership of certain banks the branches of which do business on our market. However, since the banks in the applicant countries are mainly internationalised and privatised, or well on the way to so being, some EU states will have much more difficulty in respect this EU norm than the applicant countries.

More important than this will be changes in the public mood with reference to “foreign banks”. That is, public attitudes to the EU, globalisation and foreign ownership go, as a rule, through a number of phases. Initial rapture is followed by revulsion and disappointment, when the first problems appear, showing that there is no ideal system (this phase started in Croatia after the Rijeka banka crisis, which at the moment the scandal of foreign currency losses broke out was owned by a German state-owned bank). If the public gets cold feet at loss of sovereignty in the control of banks, it is easy to match this with arguments about essentially easier interest rates and loan conditions in an internationalised system and the vast costs that the taxpayer had to stand in the “national” system. However, bearing in mind Croatian political traditions, and the constant demand in them for stronger government interference in the economy, it is questionable whether any political elite will have any interest in preserving the achieved openness of the banking system if public pressure takes on greater dimensions than those we have seen to date. In the next few years the attitude of the public towards the opening of not only the banking system but of all segments of economic and social life will have to be attentively scrutinized. It is precisely in this attitude that the answer to the question of the possible speed of Croatian convergence on EU standards lies.

DEVELOPMENT OF THE CAPITAL MARKET

The fourth problem common to the EU and the applicant countries as well as Croatia relates to the inadequate development of the share capital market. In placing their resources, banks endeavour to minimise risks. The sources of resources of the banks are mainly not permanent (apart from their capital and the few long-term deposits)[vi], but are medium-term and short-term, which means that the banks have limited opportunities for term transformation as it is known for the sake of placing long-term funds. From this it derives that the banks cannot be any kind of substitute for genuine investors, who do not put their money into debts but into capital, and thus take on much more risk, at the same time providing lasting resources for investment in corporate operations. In addition, trading in developed share capital markets provides a transparent price for share capital, which leads to its rapid migration from firms and sectors with low profit and dividend levels into firms and branches with high profits and dividends. This ultimately ensures the quality of the investment process and stable economic growth.

Although the share capital market is the core of capitalism, it cannot develop spontaneously. The development of it requires deliberate government intervention through the provision of a legislative, information and other infrastructure necessary for the functioning of an effective market. In this area, Europe is behind the US, UK and SE Asia, and the transitional countries have on the whole joined this old and inglorious European tradition. After the fall of the Wall, not enough attention was devoted to the development of the capital market. Instead of providing the legal and other kinds of infrastructure for the development of the market, the countries got directly involved in the privatisation process, contributing to what we now refer to as the crisis of "crony capitalism", which has essentially put at risk the credibility of the transition and capitalisation as the target system.[vii] In the first phase, government officials endeavoured to avoid, or carry out a very limited, allotment of shares. In the second phase, under pressure of high budgetary deficits, they resorted to the sale of the big state corporations to finance shortfalls in the budget. The essential elements of the development of a capital market, such as the passing of legislation, the establishment of capital market regulatory institutions (Securities Commission, Agency for Protection of Market Competition), privatisation of companies by private sale on the market, the establishment of cheap and efficient platforms for secondary trading all occurred sporadically and on the whole too late.[viii] Thus we arrived at the situation as shown in Table 5. The data show that Europe (as symbolised by Germany) is globally way behind the US, that the applicant countries (with the exception of Germany) range around the value of the indicator for Germany, while Croatia is quite clearly behind everyone, including the advanced applicant countries.[ix]

Table 5. Indicator of degree of development of share capital market

Country	Market capitalisation / GDP (%)
Czech R.	35
Hungary	56
Slovakia	24
Slovenia	27
Poland	17
Estonia	28
Lithuania	30
Latvia	7
Russia	26
Croatia	14
SAD	80
Germany	24

Source: Dalić (2002) and Šonje (2001)

There is a developed awareness in the EU of the importance of developing the capital market, as well as the fact that the fragmented national legislations and traditions are one of the main obstacles in the way of the development of an effective European capital market. In its action plan for financial services, worked out in 1999 and accepted in 2000, the EU mapped out the creation of a single European financial market by 2005, which primarily relates to the capital market. Unlike the EU, which has a clear target and determined deadlines, and unlike the more developed transitional countries like Hungary and CR, whose markets are relatively well developed for European conditions, Croatia[x], with one of the lowest ratios of market capitalisation, is right at the margin of global changes. The reasons need to be sought at several levels. First of all, privatisation in an unregulated environment, which relied on the self-managing and centralised state model, and not the model of allotment of shares, contributed to the dissemination of distrust and a feeling of injustice. Ultimately, it was not possible to create broad-based shareholding. Secondly, Croatia is a country that had fallen behind the advanced applicant countries in economic and business education, and understanding of the importance, manner of function and regulation of the capital market remained limited. Thirdly, in the Croatian economic elite, there is still the tradition of direct market intervention, which is not aimed at the developed of the market infrastructure, rather at the suspension or replacement of market mechanisms, which ultimately prevents the further development of a capital market, because there is a tendency to look for alternative (administrative) mechanisms for the allocation of capital. As for the deep and lasting developmental obstacles, at this moment it is not clear how and in what period of time they can be overcome, and there is a danger that the lack of development of the share capital market will be an essential limiting factor in Croatian competitiveness during EU accession.[xi]

DEVELOPMENT OF THE REGULATORY ENVIRONMENT

The process of the transition in this country is on the whole understood as the process of the adjustment of standards to those of the developed market economy democracies. It is not a rarity for politicians (irrespective of party or background) to talk of changes in laws and standards as if they were goals in themselves. This is perhaps the reason why in Croatia, from the point of view of standards, there are no insuperable gaps with the advanced applicant countries for the EU, at least in the area of monetary policy and financial services. As we have already pointed out a few times in this paper, convergence in standards is important, but it is not a crucially determining factor in convergence with the EU, and hence we shall devote only a few lines to specifically legal issues, not letting slip of the fact that issues of standards are not any problem at all at the moment when the economic (structural), interest and socio-psychological lines of force are at work in conformity with the standards in the EU.

As already said, the CNB Law of 2001 is mainly harmonised with EU standards. In the process of passing it, the opinions of experts for central banking from the European Commission were made use of, in order to widen the understanding of the necessity of accepting certain standards, which is the first case of the kind in our legislative practice, as far as money and banking are concerned. Very likely this is one of the reasons why our Central Bank Law is already harmonised with the main normative parameters of the European Commission.

The new Banks Law conforms to EU standards to such a level that Croatia, with the amendments to this law and according to the definitions of some byelaws, certainly meets the requirements for EU membership. It is harmonised with the directives of the EU related to the starting of and carrying out the business of loan institutions, the rehabilitation and liquidation of loan institutions, annual and consolidated report, capital adequacy and deposit security, to mention only a few of the most important areas. Since by 2005 Basel II will start to be applied, this will be an opportunity for a further step in convergence on EU standards.

Of course, there are many legal approaches that contain provisions that will have to be abolished or modified on the way to the EU (Law concerning Loan Business with Foreign Countries, the Inland Payments Clearing Law, the State Agency for the Security of Deposits and the Rehabilitation of Banks Law), just as there are legislative areas that are not sufficiently standardised in comparison with the EU (electronic financial business, security instruments, registers, regulation of financial conglomerates). However, these are areas in which, without any major problems, via laws or byelaws, convergence with EU can be achieved within the period for joining.

The only serious open area is that of foreign currency operations. This area will be treated in a separate chapter, because the current proposals for new solutions do not guarantee any progress on the road towards the EU.

OPENNESS TO THE FLOWS OF INTERNATIONAL CAPITAL

The degree of openness, and the dynamics of further opening up, to the flows of international capital are the most important elements of economic policy in a small and open country like Croatia. All the financial issues that we considered in the previous chapters essentially depend on how the country defines itself vis-à-vis international financial currents. An error in this area can cancel out the effects of an excellent monetary and financial policy, but at the same time, the effects of bad monetary and fiscal policies can largely annul an intelligent policy of opening up to international capital. The reason for such importance being ascribed to international financial flows is that foreign currency inflows and drains are a much more important determinant of changes of money supply (which is to a large extent of foreign origin), supply of loans, savings and economic activities than the monetary policy of one's own central bank.[xii] In other words, what for the USA is represented by Fed actions is in Croatia foreign currency flows.

Since in the EU accession process a greater degree of openness of the Croatian economy is to be expected, the anyway already important foreign currency issues will become even more important, for which reason they deserve a special place in this paper.

The current state of affairs in Croatia is such that we are very open to influxes of international capital, which is fine. Direct foreign investment and repatriation of profit have the same rights as domestic investment, the influx of foreign currency deposits is unrestricted,[xiii] and firms, banks and the government can borrow at foreign banks and on the international capital market. Certain forms of regulation do exist to do with the purchase of real estate (foreign natural persons can do this only with a special license) and of the usual reporting for the sake of the foreign debt statistics and the prevention of money laundering. On the outflow side, there are however many barriers. Citizens and firms may not have accounts with foreign banks (the corporate sector can, with special permission) or invest in foreign securities, and direct investments abroad can be made only be firms. The easy inflow and difficult outflow of capital make the current system asymmetrical and irrational, and the possibilities for the international diversification of portfolios are limited. In other words, the regulation system is created in such a way as artificially to create a larger supply of foreign currency in the country (and thus creating artificial pressure for the currency to appreciate) than that which would exist if the international currency flows were liberalised on the outflow side as well. The causes of this state of affairs should be sought in the heritage of the regulations from ex-Yugoslavia[xiv], in which the foreign currency legislation was written in such a way as to solve the constant problem of foreign currency shortage and to enhance the spread of government control over the economy.

However, the inherited regulations are not very distant from the standards that the EU at the moment requires from Croatia. During the four years after the signing of the SAA, i.e., by 2006, Croatia has to enable EU citizens free trade in land (apart form agricultural land, forests, nature reserves and the maritime zone) on conditions identical to those for Croatian citizens. Four years after the signing of the SAA, Croatia has to enable free portfolio investment and transactions relating to financial loans in a period of up to one year. The other conditions are already met in Croatia (convertibility on current account, freedom of direct foreign investment, free commercial loan transactions with a maturity period of longer than a year).

The conditions that the EU imposes on Croatia are similar to the inherited regulations in that they still deal more with the inflow than the outflow side. Probably this is one of the reasons because of which the proposal of the new Foreign Currency Business Law, of May 2002 (http://www.hnb.hr/propisi) are still based on a sceptical point of view with respect to liberalisation of international capital flows. The positive moves in the draft Law are mainly of a technical nature[xv] and the only essential new departure is the possibility of buying foreign securities. However, this too is limited to the government bonds of OECD countries, and it is hard to imagine any interest on the part of domestic investors for securities with low yields and low risk, because there are already plenty such securities and financial service providers that supply them (investment and pensions funds) on the domestic market. Still open is the question of how much the possibility of prescribing the lowest credit rating for foreign issuers whose bonds can be bought with restriction by residents will employed. In essence, the new foreign currency law has retained most of the outflow restrictions of the old law and in this way failed to inject some equilibrium into this sensitive part of the economic regulations.

A similar spirit prevailed with respect to the ability of foreigners to invest in Croatian securities. Non-residents may not invest in cashier bills of the CNB or in treasury bills, but may in other securities if the period maturity is longer than 6 months and if they retain them to the maturity period. In addition, the CNB may prescribe restrictions to do with terms and the possibility of making use of all short-term securities (Art. 26, Draft Foreign Currency Business Law). This restriction shows the nervousness of the government about the sudden movement of non-residents into short-term securities, which could equally rapidly be turned into a sudden outflow of capital. However, this fear is mainly without foundation, because:

- for quite a long time Croatia has had lower rates of interests and worse credit ratings than the applicant countries in this area, which means that short-term international money will probably give Croatia the miss for quite some time to come (it will tend towards areas with bigger yields and smaller risk), because at the moment there is no indication of any changes in these relations;
- because of its size Croatia will probably never be a main speculative target, for speculators for their operations required developed, large and liquid markets with low transaction costs of trading in financial

instruments. In much worse conditions, and with much higher interest rates, in the second half of the nineties, Croatia was exposed to the inflow of short-term capital, and this did not hurt it even then;
- the EU provides for the possibility that in the event of there being a major menace to the exchange rate policy and the balance of payments restrictions may be introduced. For this reason it is a mystery why restrictive measures and instruments have been incorporated into the law when they can be regulated by byelaws should a crisis make it necessary.

The possibility of intervening in the area of the freedom of the flows of international capital fits in with the well-known McKinnon theory (1991) of gradual liberalisation. It is important to note that the views advanced here are not an advocacy of unconditional liberalisation, rather the question is raised as to why those who proposed the new foreign currency law turned the reaction to an exceptional economic situation into a system that is built into the law. A more liberal wording of the law would not mean any ability to react to a crisis set off by changes in international capital movements. In addition, the beginning of the functioning of the economy in a financially liberated environment in the phase when the government can still occasionally intervene in the free market would be an important gain, because of the possibility of getting people used to an environment of the kind that awaits us in a few years time, but without the government being able to rescind individual freedoms. In this way the outflow side remains mainly closed, irrespective of the asymmetry that such a solution might create in the currency market (a possible structural excess in the supply of foreign currency), while functioning in a liberalised environment has been deferred to the moment when such liberalisation will be irreversible. We are perhaps missing a chance to get ready now for the total liberalisation that awaits us on entry into the EU.

CONCLUSION

Croatia can be satisfied with its tempo of convergence on the EU to do with the narrowly defined monetary indicators: inflation, interest rates and exchange rate. However, there is ground for concern in the indicators of the financial deficit that takes us essentially away from EU standards. The structure of the banking system, which is seen in interest margins and in the internationalisation of the ownership structure, is very suitable for EU accession, and this evaluation can also be applied to the other financial services providers, which are integrated into the systems of international financial conglomerates. Nevertheless, the share market is worrying undeveloped in Croatia, and can in the long run be a serious developmental handicap which will limit the competitiveness of the Croatian economy in the EU. For this reason the creators of economic policy must undertake urgent actions in this area. As for convergence on the EU in the area of standards, we can be on the whole satisfied, especially with the central bank and commercial banks laws. This evaluation does not apply, however, to the area of foreign currency legislation. In this area a minimum of progress has been recorded since the emergence from the former Yugoslavia, and the draft of the new foreign currency law has let slip the opportunity for convergence with EU standards. The economic and financial systems will have gradually to adapt themselves to functioning in a liberalised environment. The retention of restrictive regulations to the last moment marks this area as the key area of vulnerability on the way to the EU.

RECOMMENDATIONS

- Make use of the introduction of Basel II for the adjustment of byelaws and regulations governing banking operations to the standards of the EU.
- Continue to affirm the independence of the central bank as an incontestable standard, and resist any unnecessary attempt to encroach upon it with the aim of diminishing central bank independence.
- Essentially step up the activities of the Republic of Croatia Securities Commission in the area of the European action plan for financial services and the introduction of international standards into the funds industry (GIPS, for example, *the Global Investment Performance Standard*).
- Design and implement measure for a more rapid development of the share capital market.
- Liberalise international capital flows, while retaining the possibility to restrict them in exceptional crisis conditions, instead of the current conception, according to which actual restrictions on international capital flows are retained.

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[i] *The ECB and the Eurosystem (ECB and the central banks of the states members of the EMU) are not primarily political institutions and they have limited political influence. However, their political importance may not be underrated, not only because of their informal influence, but also because of the formal role of the ECB in making political decisions in the EU. The ECB provides opinions to the European Commission when it discusses financial and monetary issues, reports to the EP, and is directly involved in the economic dialogue between the EU and the applicant countries. The economic dialogue is coordinated by the European Commission. The objective of the economic dialogue is an exchange of opinions with the applicant countries in the pre-accession phase and preparation of them for reciprocal oversight procedures, which will be activated immediately after EU entry. For this reason great importance needs attaching to the fact that in the ECB Bulletin of July 2000, the following was written: In recent times, the parliaments of Hungary and Poland have debated draft amendments to the central bank laws, which would de facto reduce the degree of independence of the central banks. Acceptance of any amendments that, in essence, weaken the capacities of the central banks in their fight for price stability would give rise to serious concern in the EU accession process of these countries (ECB, July 2002).*

[ii] *The expert group for bank control at the BSI in Basel is constantly working on the unification of the so-called best practices in the regulation of banking systems in order to provide adequate and unified levels for the capital adequacy of the global banking system, which particularly relates to large international banks. After the first guidelines of 1988, the implementation of the second lot of guidelines is expected from 2005 only. The greatest changes being introduced refer to the acceptance of the influence of operational risks in the calculation of the capital needed, and greater reliance on internal rating systems of banks in the evaluation of lending risks (BIS, 2001).*

[iii] *The differences with respect to CR and Slovakia need to be interpreted provisionally. In the banking statistics of these countries, a good part of the bad assets are still shown in the balance sheets, which distorts comparisons with countries such as Croatia, in which banking balance sheets have been purged of bad assets.*

[iv] *Reporting procedures in the banking system are adapted to EU standards. Internal models for risk management and other operational procedures are on the whole adapted to EU standards under the influence of foreign owners and internal and external auditors. In general, the operations of international banks and firms have very positive external effects in the form of the spread of knowledge, procedures, business relations, morality and codes of conduct that prevail in the developed world. This effect need not be overemphasised, however, since local know-how and culture are the dominant determinations of the setting in which the foreigners are located. However, the influence should not be underrated either.*

[v] *Data from Spain are not available in this dbase.*

[vi] *Interbank long-term loans need not be looked upon as long-term sources at the level of the global consolidated banking system, because ultimately it can be financed only with capital, quasi-capital and long-term non-banking deposits.*

[vii] *Crony capitalism means a system in which capital is not controlled by the most competent who have managed to survive in the open market, but those who at the moment of privatisation were closes to the government officials who allocated the capital or those who through their influence on state intervention instruments managed to ensure better operating conditions for their firms.*

[viii] For example, the two key regulatory institutions mentioned in the text started to be worked on in Croatia only in 1995/96, which means that the first phase of the transition and privatisation was carried out in a de facto unregulated environment.
[ix] The numerator of the ratio is the market value of share capital of a company placed on the stock exchange.
[x] The data need interpreting with caution because there is no internationally comparable and reliable dbase in which the share of capitalisation deriving from bonds is unambiguously set off from the part deriving from shares.
[xi] There is an alternative way of looking at the problem, taking off from the fact that Croatia is too small to be able to develop an independent capital market to any great extent. According to this viewpoint, the shares of the important firms will be quoted on the international capital markets when the firms are mature enough for this step. It would seem that the examples of Pliva and Zagrebacka banka speak in favour of this. However, there is still the problem of the manner of arriving at fresh capital for medium-sized firms that the international markets will not be interested in, or for which the transaction costs of issuing new shares on the international market will be prohibitively large.
[xii] This goes only for little countries. In big countries foreign currency inflows and outflows are relatively of lesser importance consider the GDP, and so the importance of domestic monetary and fiscal policy is incomparably greater.
[xiii] Unless we count as restriction the not very sensible obligation for every transaction worth more than 105,000 kuna, irrespective of whether it is in cash or not, has to be reported to the Prevention of Money Laundering Office.
[xiv] The currently valid foreign currency law was written in 1993, in a hurry, and with a single objective – the liberalisation of currency transactions (Article 8, Charter of the IMF). This provision was formally accepted two years later for formal reasons (Croatian had not yet settled its affairs with creditors relating to the debt inherited form the former SFRY), but de facto acceptance of this obligation occurred in October 1993.
[xv] The areas are:

1. *governing the trade in gold in other instruments;*
2. *a liberal system of areas of direct foreign investment (no novelties, only the material is simply and systematically arrange din one spot;*
3. *government of the issue, classification and sale of the so-called Global Depository Receipts;*
4. *the government of the issue, classification and sale of foreign securities in the Republic of Croatia;*
5. *the superfluity of the Loan Business With Foreign Countries Law;*
6. *the possibilities of making long-term loans to non-residents.*

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